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Central Intelligence Agency

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DIRECTORATE OF INTELLIGENCE

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Yugoslavia: Prospects for the Economy

SUMMARY

Yugoslavia's economy made a good showing in 1984, producing its highest growth rates in four years and improving the country's external financial position through strong export gains. The economy, however, is off to a poor start in 1985 due largely to severe winter weather which cut into industrial output, and the government is under increasing pressure to take stronger steps to reduce inflation and protect the standard of living. Difficult negotiations with Western creditors and the IMF lie ahead especially since Belgrade has been taking a more assertive line in recent talks. During her visit to Washington, Premier Planinc will seek additional support for her program for economic recovery. [redacted] 25X1

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Introduction

Aided by financial support from the IMF, Western governments, and banks, Yugoslavia's economy made a good showing in 1984. Growth reached its highest rate in four years, and strong export gains improved the country's external financial position. These results prompted the IMF to call 1984 a "watershed" year for Yugoslavia, but the Fund's optimism may be premature. The economy is off to a poor start in 1985, and the Planinc government is under growing pressure to deal with rising inflation and falling living standards. Western creditors are looking for evidence of structural adjustment to ensure long-term growth and external balance, but prospects for such changes are uncertain at best. More years of slow economic growth and difficult negotiations with creditors seem to lie ahead. [redacted] 25X1

Performance in 1984

In 1984, Yugoslavia recorded its strongest economic growth since 1980 as gross social product--roughly equivalent to GNP--rose 1.7 percent. Aided by increased imports of materials, industry led the recovery with a 5.5-percent increase in output following two years of near stagnation. The upswing centered in export sectors which benefited from growth in Western demand and enhanced competitiveness resulting from large devaluations of the dinar since 1983. Domestic demand continued to decline in response to IMF-mandated austerity measures intended to ease inflationary pressures, limit import requirements, and free up production for export. Investment again shouldered most of the reduction although personal consumption also fell for the fourth consecutive year. [redacted] 25X1

Yugoslavia extended the improvement in hard currency trade and payments performance that began in 1983. A 9-percent increase in exports enabled Belgrade to reduce its hard currency trade deficit by $500 million while easing restraints on imports. The convertible currency current account surplus rose by $246 million to $850 million, a sharp turnaround from the $1.6 billion deficit in 1982. Foreign exchange reserves grew by $536 million, exceeding the IMF target of a $500 million increase. But even with these gains, Belgrade had to reschedule debts with Western banks and governments for a second consecutive year and draw on IMF standby credits. [redacted] 25X1

The pickup in economic growth and improved external performance have not won praise from the Yugoslav people dissatisfied with rising inflation and unemployment. Inflation accelerated to an annual rate of nearly 60 percent--partly as a result of lifting price controls and the dinar devaluations. The price increases together with restraints on wage gains have cut real personal income by 35 percent since 1980. The reduction of private consumption has been much less severe because withdrawals from dinar and private foreign exchange accounts and widespread moonlighting have helped buoy spending. But even with this cushion, the public has grown increasingly cynical about the government's ability to manage the economy. In 1984, the number of economically motivated labor strikes rose to its highest level in five years. Moreover, income disparities between the relatively prosperous north

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and underdeveloped south have widened, compounding Yugoslavia's regional rivalries. [redacted] 25X1

1985 Off to a Poor Start

First results for 1985 have all but dashed Belgrade's hopes of improving significantly on 1984 performance. Growth of industrial production slumped sharply in the first months of the year, largely as a result of exceptionally severe winter weather. Already high inflation accelerated to an annual rate of more than 80 percent in April, prompting the government to reimpose some price controls. Most important, external payments performance deteriorated sharply. The first quarter hard currency trade deficit of $215 million was nearly 50 percent larger than the first quarter deficit a year ago. Imports rose 5 percent largely as a result of increased oil purchases while exports declined. By March, Belgrade had reduced its foreign exchange reserves by more than the increase recorded in 1984. Some of the economy's losses will probably be recouped later this year, but Yugoslavia's goal of recording major gains over 1984 is unlikely to be met. [redacted] 25X1

After a reasonably good start, Yugoslavia's dealings with Western creditors--particularly commercial banks--have also soured recently. Belgrade initially opposed negotiation of a new standby agreement with the IMF, but at the insistence of private and official creditors, the Yugoslavs reached agreement with the Fund in mid-March. In return for a $300 million standby credit, Belgrade will continue movement toward positive real interest rates, devaluation of the dinar to offset inflation, and tighter control over domestic credit and government expenditures. [redacted] 25X1

In late March, Yugoslavia and Western creditor governments reached agreement on rescheduling roughly $800 million in debts coming due between 1 January 1985 and 15 May 1986. The agreement reschedules 90 percent of principal over nine years with a four-year grace period. Although the creditors promised future support in the pact, the rescheduling fell short of Belgrade's demand for an agreement covering debts maturing in 1985-88. [redacted] 25X1

In contrast, negotiations with commercial banks to reschedule $3.6 billion in debt due in 1985-88 broke off in April. [redacted] 25X1 25X1 Yugoslavia's tough stance probably reflects pressure on Premier Planinc's government for greater concessions from the banks following its failure to obtain a multiyear rescheduling from Western governments and the Yugoslavs' perception that they deserve the same considerations granted to Mexico. The banks and the Yugoslavs are to resume formal discussions in late May. [redacted] 25X1 25X1

The short-run impact of the delay is not large because banks have already agreed to a moratorium on debts falling due through 30 June 1985, and no new credits are involved. The Yugoslav stance, however, may have been a miscalculation [redacted] 25X1 An extended delay could also make 25X1

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bankers less willing to provide needed trade financing. The IMF, in formally approving the 1985 standby loan, stipulated that Yugoslavia cannot make the second drawing on the credit line unless a rescheduling agreement is reached with commercial creditors by 29 August. 25X1

The Problem of Structural Change

If final results for 1985 fall short of last year's gains, doubt may be cast on Yugoslav and IMF claims that Belgrade's adjustment efforts are beginning to produce the changes needed to achieve both growth and external balance. The IMF termed last year's performance a "watershed" for Yugoslav economic policy on grounds that Fund prescriptions for lifting controls on prices and interest rates, reducing subsidies to money-losing enterprises, tying wage increases more closely to enterprise performance, and devaluation of the dinar were starting to promote greater efficiency and shift resources to the export sector. Western creditors, however, remain skeptical that structural adjustment is taking place. They are looking for more than restraints on domestic demand, increases in administered prices and interest rates, and maintenance of a competitive exchange rate. They are seeking evidence of systemic changes needed to control underlying inflationary forces and to reduce the economy's dependence on foreign borrowing:

-- Reducing the power of regional authorities to exert controls that prevent goods, capital, labor, and foreign exchange from flowing to their most efficient uses.

-- Enforcing greater financial discipline on enterprises through tougher application of bankruptcy laws, controls on intraenterprise credits, and reduced subsidization of inefficient producers.

-- Reducing the influence of political criteria on investment decisions.

-- Changing wage determination to link earnings more closely to productivity.

Progress has been made in these areas, but the IMF believes much more needs to be done. 25X1

We doubt that Belgrade has the political willpower or ability to enforce this discipline. From Belgrade's perspective, the costs of reform are high--inflation, sliding living standards, bankruptcies, and rising unemployment--and the payoff is neither quick nor certain. Many of the measures challenge the basics of the country's self-management system and conflict with ethnic or regional interests. The extremely heterogenous nature of Yugoslav society has made implementation of many changes impossible even under stronger central management in the past. 25X1

Change so far has been forced on Yugoslavia by creditors and the IMF, but Belgrade is trying to avoid further IMF standby programs. Judging by public statements, Yugoslav economists are divided over the wisdom and effects of IMF-sanctioned measures, and some senior leaders fear Yugoslavia is being

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forced into "neocolonial" status. The system tends to favor short-term political accommodation rather than dealing with underlying problems. The advocates of reform at best can hope for tinkering with the system and uneven implementation of measures by the regions. Meanwhile, the Planinc government will face the threat of a growing conservative backlash, fueled by pressures to ease the pain of austerity measures. [redacted] 25X1

Outlook for the Economy

The slow and uncertain pace of change in Yugoslavia and the likelihood of disappointing economic results this year may force Belgrade to revise downward its ambitious goals for growth and external payments performance through 1990. Creditors already unhappy over Yugoslavia's intransigence and delaying tactics in talks are likely to take a harder view of the country's creditworthiness and to press for continuation of strict IMF oversight. Belgrade's hopes of reflating the economy to halt the erosion of living standards and to resume faster economic growth are likely to be dashed. More years of difficult dealings with creditors and slow economic growth are probably in the offing as the economy struggles to service its $18.6 billion foreign debt. [redacted] 25X1

Planinc's Visit: Likely Issues

While in Washington, Premier Planinc probably will try to shore up US financial support for Yugoslavia, which many Yugoslav officials believe is weakening. [redacted] 25X1

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Planinc is also likely to promote the opportunities open to US firms under Yugoslavia's new joint venture law. She and other officials have highlighted the law during recent trips to other Western capitals. [redacted] 25X1

If the issue is raised, Planinc will probably play down her government's recent decision to impose some price controls. She will insist the action was needed to slow the country's inflation--now running at 80-percent. Belgrade apparently does not believe the IMF will interpret the controls as a violation of the current standby agreement. [redacted] 25X1

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